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All Industries

"Notice 2002-65" Tax Shelter
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Introduction

On October 15, 2002, the Service issued Notice 2002-65, 2002-2 C.B. 690, announcing that the Service will challenge transactions that use a straddle, one or more transitory shareholders, and the rules of subchapter S, to generate deductions that purportedly allow taxpayers to claim an immediate loss while deferring an offsetting gain in the taxpayer's investment in the S corporation.

Issues

1. Whether the S corporation and the Investor should be denied the loss under § 165(c)(2)?

2. Whether the Investor should be denied the loss under § 269 because the principal purpose of acquiring control of the S corporation was the avoidance of income taxes?

3. Whether the transaction should be recharacterized under the § 988 anti-abuse regulations?

4. Whether the Promoter, an ineligible shareholder, should be treated as the shareholder, thus making the S corporation's S election ineffective?

5. Whether under judicial doctrines (i.e., step transaction, economic substance, and substance over form), the loss deduction should be allowed?

6. Whether the legal, promoter fees, and "out of pocket expenses" should be allowed?

7. Whether the § 6662 accuracy-related penalty applies to Notice 2002-65 transactions?

8. Whether the § 6662A accuracy-related penalty provisions apply to Notice 2002-65 transactions?

Conclusions

1. The S corporation and the Investor should be disallowed the losses under § 165(c)(2).

2. The losses should be disallowed under § 269, because the principal purpose of this transaction was the avoidance of income taxes.

3. The transaction should be recharacterized, and the loss accelerated to a time prior to the Promoter Shareholders' redemption, under the § 988 anti-abuse regulations.

4. The corporation's S election was ineffective because the Promoter, an ineligible shareholder, should be treated as the shareholder.

5. Under judicial doctrines (i.e., step transaction, economic substance, and substance over form), the benefit of the deduction claimed upon the termination of the loss leg of the straddle should be disallowed. These arguments should be utilized with discretion in appropriate cases and only after detailed development.

6. The transaction costs incurred in connection with this transaction, including promoter's fees, accounting fees, legal fees and consulting fees, are not deductible under §§ 162 or 212.

7. The § 6662 accuracy-related penalty applies to Notice 2002-65 transactions.

8. The § 6662A accuracy-related penalty provisions apply to Notice 2002-65 transactions.

Facts

The facts below describe a typical Notice 2002-65 transaction. Accordingly, some of the facts may vary depending on the transaction being examined. A typical Notice 2002-65 transaction involves a number of precisely arranged steps which are intended to ultimately result in a deductible noneconomic loss for the Investor. The key components of a Notice 2002-65 transaction are (1) the use of a straddle that is not subject to the mark to market rules of § 1256, (2) an S corporation[1], (3) and one or more transitory shareholders.

First, the Investor and and one or more employees of the Promoter form a corporation (Promoter Shareholders) [2]. The shareholders of the corporation elect to be treated as an S corporation under § 1362(a). The Promoter loans $800 to the Promoter Shareholders.[3] Investor contributes $200 in exchange for 200 shares of S corporation

[1] A Notice 2002-65 transaction can involve a partnership rather than an S corporation. See Notice 2002-65.
[2] For the year 2001, the Promoter shareholders held their interest through limited liability companies, which are treated as disregarded entities for federal tax purposes.
[3] The dollar figures used in this paper are for illustration purposes only, and therefore, do not necessarily correspond to actual transactions either in amount or relation to each other.

voting stock (a 20% equity interest). Investor's basis in the S corporation stock is $200. The Promoter Shareholders contribute $800 (obtained from the Promoter) in exchange for 800 shares of S corporation non-voting stock (an 80% equity interest). The Promoter Shareholders' total basis in the S corporation stock is $800. The price per share of the voting stock and non-voting stock is identical. In addition, the Investor loans $4,000 to the S corporation. The loan increases the Investor's basis in the S corporation to $4,200. The S corporation uses the contributed cash to establish an account with Bank. Bank is the custodian of the account and is authorized to buy or sell foreign currencies upon instruction from either the S corporation or the Promoter.

Second, in taxable Year 1, S corporation acquires long and short positions (straddles) in forward interest rate swaps and minor foreign currency trading. The straddles acquired by the S corporation could also be comprised of financial instruments other than interest rate swaps or foreign currency forward contracts. Such positions are substantially offsetting so that as one position increases in value, the other position will decrease in value to substantially the same degree.

Third, the S corporation terminates the gain leg of the straddles for a gain of $10,000. The $10,000 gain is allocated to the shareholders pro rata according to their stock ownership. Accordingly, the gain is allocated $2,000 to the Investor and $8,000 to the Promoter Shareholders. Under § 1367(a)(1), Investor's basis in the S corporation stock is increased by $2,000 to $6,200, and the Promoter Shareholders' total basis is increased by $8,000 to $8,800. Immediately after the gain leg is terminated, the loss position is "locked in" by putting on a "switch position,"[4] and the S corporation is left with a net unrealized loss of $10,000.

The proceeds from the terminated gain leg are invested either in quarterly bonds or OTC Deposit Annexes (Synthetic CDs). The quarterly bonds or Synthetic CDs provide collateral for the $10,000 unrealized loss position. Accordingly, when the loss leg is terminated (Step 5) the quarterly bonds or Synthetic CDs will be used to cover the loss (i.e., neutralize the loss).

Fourth, the S corporation forms a single member limited liability company (Trading LLC), which is treated as a disregarded entity and thus a division of the S corporation. As discussed below, an affiliate of the Promoter (the Promoter Affiliate) manages the assets of Trading LLC.

Fifth, the S corporation redeems the stock of the Promoter Shareholders for $825, an amount that is slightly higher than the Promoter Shareholders' initial investment. The Promoter Shareholders claim a loss of $7,975 on the redemption.[5] The S corporation files an election under §1377(a)(2) to treat the S corporation's taxable year as though it

[4] Generally, the simultaneous closing of the gain leg and the reestablishment of the straddle is known as a "switch" transaction. The "switch position" is the replacement leg that reestablishes the straddle.
[5] The Promoter LLCs use this loss to offset the allocated income in step three or gains from other abusive transactions in which they participate.

consists of two separate taxable years, with the first year ending on the date of the redemption.[6]

Sixth, following the redemption but within the same calendar year, the S corporation terminates the loss leg. This generates a $10,000 loss which is allocated to the Investor. Because the Investor has inadequate stock and debt basis to claim the entire $10,000 loss and in order to claim that the overall transaction has a profit objective, the Investor makes an additional contribution to the S corporation.[7] This post-redemption capital contribution can take any form including cash, a stock investment account, or an operating business.

Generally, Notice 2002-65 transactions are marketed with an overall fee structure of 5% of the capital tax losses and 6% of the ordinary tax losses. Initially, some fees are paid directly to the Promoter, accountants, and attorneys. S corporation also enters into a management agreement with the Promoter. As part of the agreement, S corporation agrees to pay a fee equal to a percentage (e.g., ¼ of 1%) of the net fair market value of S corporation's account on deposit with the Bank. However, after Promoter Shareholders' stock is redeemed, the fee is waived.[8]

The S corporation enters into a management arrangement with the Promoter Affiliate. The fee agreement is a two part agreement consisting of a Currency Consulting and U.S. Government and Agency Securities Trading Agreement (the Consulting Advisory Fee) and fees for investment advisory and management services. The majority of the fees are paid pursuant to the Consulting Advisory Fee.

The only assets subject to Currency Advisory Fee are the assets held by Trading LLC. Trading LLC's only asset is the balance in the trading account after the redemption of the Promoter-Shareholders. The balance is equal to the initial capital contribution less the redemption amount, the loan from shareholder, and interest on the initial cash deposits plus or minus any actual trading gains or losses.

The Consulting Advisory Fee approximately equals the amount of funds the Promoter Affiliate is to manage (i.e., the assets held by Trading LLC) over a two year period. The Consulting Advisory Fee is either paid by the Investor or by the S corporation from assets contributed to the S corporation by the Investor after the redemption of the Promoter Shareholders. If the Consulting Advisory Fee was paid by Trading LLC, there would be no assets left in the Trading LLC for the Promoter Affiliate to manage.

[6] Notice 2002-65 states that a transaction is substantially similar to the one described in the notice if the gain and loss legs are triggered in separate taxable years, or if, at the time relevant for making such determination, the corporation in the transaction has not elected under § 1377(a)(2) to treat the S corporation's taxable year as though it consisted of 2 separate taxable years

[7] Any loss in excess of the Investor's stock and debt basis is suspended and carried forward to a subsequent year.

[8] Taxpayers claim that the fee is waived because of the short period during which the Promoter provided services to the S corporation and because a continuing relationship between a Promoter Affiliate is established. The effect of waiving fees as of the date of redemption of the Promoter Shareholders and setting up a new fee arrangement is that the S corporation does not have any management fees when the Promoter Shareholders own stock and substantial fees when Investor is the sole shareholder.

After paying the Consulting Advisory Fee in an amount approximately equal to the assets initially held in the Trading LLC (an amount slightly greater than Investors initial equity and loan contribution ($ 4,200)), the Promoter Affiliate invests most of the Trading LLC's assets in US Treasury securities or other cash equivalents.

LEGAL THEORIES

1. The S corporation and the Investor should be disallowed the loss under § 165(c)(2).

Section 165(a) allows as a deduction any loss sustained during the year and not compensated by insurance or otherwise. Losses claimed by individuals, other than casualty losses, are limited by § 165(c) to (1) losses incurred in a trade or business and (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business. The requirements of § 165(c)(2) were applied to certain straddle transactions in Fox v. Commissioner, 82 T.C. 1001 (1984). The Tax Court found that § 165(c)(2) requires that the taxpayer enter into the transaction "primarily for profit." 82 T.C. at 1019-21. See also Dewees v. Commissioner, 870 F.2d 21, 33 (1st Cir. 1989), and the cases cited therein. This "primary profit motive" test (which also applies to other deductions requiring a business or profit motive, such as § 162), has its origins in the Supreme Court decision, Helvering v. National Grocery Co., 304 U.S. 282 (1938), which interpreted a predecessor of § 165(c). See also United States v. Generes, 405 U.S. 93, 105 (1972) ("dominant motive" required).

The application of § 165(c) does not require a finding that the transaction lacks economic substance. For example, the Tax Court in Fox found that because the taxpayer did not meet the requirements of § 165(c)(2), it did not have to find that the transaction was a sham. See also Smith v. Commissioner, 78 T.C. 350 (1982), aff'd without published opinion, 820 F.2d 1220 (4th Cir. 1987), where the Tax Court found certain straddles not to be shams, but at the same time disallowed the resulting losses because the taxpayers lacked the requisite economic profit objective under § 165(c)(2).

In Ewing, 91 TC at 418, the Tax Court derived the following guidelines from Fox:

> (1) The ultimate issue is profit motive and not profit potential. However, profit potential is a relevant factor to be considered in determining profit motive.
>
> (2) Profit motive refers to economic profit independent of tax savings.
>
> (3) It is the overall scheme which determines the deductibility or nondeductibility of the loss.
>
> (4) If there are two or more motives, it must be determined which is primary, or of first importance. The determination is essentially factual, and greater weight is to be given to objective facts than to self-serving statements characterizing intent.

(5) Because the statute speaks of motive in "entering" a transaction, the main focus must be at the time the transactions were initiated. However, all circumstances surrounding the transactions are material to the question of intent.

In applying the profit motive test to the Notice 2002-65 transactions, the Investor initiates the transaction by communicating a targeted tax loss to the accountant as a "solution" to offset federal income tax liabilities. The Promoter then creates a trading portfolio to reach the targeted tax loss. The Investor's fees for the transaction are generally 5% or 6% of the targeted tax loss. Any reasonable expectation of earning a profit on the straddle transaction is greatly outweighed by the fees paid. After the targeted tax loss is achieved in Year 1 (when the loss leg of the straddle is terminated), the Investor attempts to establish profitability through unrelated activities in subsequent years.

2. The losses should be disallowed under § 269, because the principal purpose of this transaction was the avoidance of income taxes.

Section 269 provides that any person or corporation who acquires control of a corporation and the principal purpose of such acquisition was evasion or avoidance of federal income tax by securing the benefit of a deduction, credit or other allowance which such person or corporation would not otherwise enjoy, the Secretary may disallow such credit, deduction or other allowance. For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

Tax avoidance constitutes the principal purpose of an acquisition when it outranks or exceeds any other purpose. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom. Section 1.269-3(a). The principal purpose determination is made at the time of the acquisition. Hawaiian Trust Co., Ltd. v. U.S., 291 F.2d 761 (9th Cir. 1961). Subsequent events may demonstrate that the acquirer's original purpose was tax avoidance because the acquisition of control was merely the first step in a multi-step transaction. Swiss Colony Inc. v. Commissioner, 52 T.C. 25 (1969), aff'd, 428 F.2d 49 (7th Cir. 1970). However, later developments, such as the acquirer's postacquisition discovery of a tax advantage or the later unrelated acquisition of a profitable business, will not negate a business-related principal purpose which was established as of the time of the acquisition. Hawaiian Trust, supra.

In a Notice 2002-65 transaction, the Investor acquires control of all of the voting stock of the S corporation at or near inception, but the Investor does not become the sole shareholder (and thus allowing the economically accrued losses to flow through solely to the Investor) until the pre-arranged redemption of the Promoter Shareholders' stock. Prior to such redemption the Investor is entitled to only 20% of the gains and losses. After the redemption the Investor is entitled to 100%. By pre-arrangement, the

redemption always occurs after the gain leg is closed but before the loss leg is closed so that the Investor is allocated 100% of the straddle loss while recognizing only 20% of the straddle gain. At the time of the redemption, the loss has already economically accrued and it has been locked-in and neutralized. See Inductotherm Industries v. Commissioner, T.C. Memo 1984-281 (Post-acquisition deductions and allowances subject to disallowance under § 269 where they had economically accrued prior to the acquisition).

In this situation, the Investor arguably meets the 50% control requirement of § 269(a) when the Investor purchases the 20% interest in the S corporation (which gives the Investor 100% of the voting control of that corporation). However, the Investor cannot achieve the Investor's purpose (to have 100% of the economically accrued losses flow through to the Investor) without also causing the corporation to redeem the Promoter Shareholders' stock. Thus, it is necessary to measure the § 269(a) control requirement after taking such redemption into account. Swiss Colony, supra (control requirement of § 269(a) tested after series of integrated steps completed, even though requirement nominally satisfied earlier). Further, a redemption of the stock of another shareholder constitutes a mechanism by which the remaining shareholder can acquire control of the corporation for purposes of § 269(a). Younker Brothers, Inc. v. U.S., 318 F. Supp. 202 (S.D. Iowa 1970).

Pursuant to section 269(c), only 80% of the loss would be disallowed. That is, the Investor should be allowed to offset the gain completely and not recognize only the portion of the loss that was truly secured by the taxpayer's acquisition.

3. The transaction should be recharacterized, and the loss accelerated to a time prior to the Promoter Shareholder's redemption, under the § 988 anti-abuse regulations.

Sections 985 through 989 of the Internal Revenue Code, enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions. Section 988(a)(1)(A) provides that foreign currency gain or loss attributable to a "Section 988 transaction" is computed separately and treated as ordinary income or loss. The legislative history of §§ 985 through 989 suggests a consistent concern about tax motivated transactions. The Senate Finance Committee Report accompanying the Tax Reform Act of 1986 stated that one reason for the enactment of these provisions was to address opportunities existing under prior law for taxpayers to engage in tax-motivated transactions. S. Rep. No. 313., 99th Cong., 2d Sess. 450 (1986). Accordingly, in enacting §§ 985 through 989, Congress granted broad authority for the Service to promulgate regulations "as may be necessary or appropriate to carry out the purposes of [§§ 985-989] . . .." Section 989(c). The legislative history to the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), in discussing the law prior to the enactment of TAMRA, stated that "[t]he Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of [§§ 985-989]. For example, the Secretary may prescribe regulations appropriately recharacterizing transactions to harmonize the general realization and

recognition provisions of the Code with the policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

Under the authority of § 989(c), the Service has issued §1.988-2(f), which provides in part as follows:

> If the substance of a transaction described in §1.988-(1)(a)(1) [i.e., a § 988 transaction] differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with their substance . . . .

If it is determined that the Investor did not own all or substantially all of the stock of the S corporation holding the foreign currency positions from the outset of the transaction, and that the participation of the Promoter Shareholders must therefore be taken into account, § 1.988-2(f) can be used to accelerate recognition of the loss leg of a foreign currency straddle prior to the redemption of the Promoter Shareholders and the corresponding increase of the Investor's interest in the S corporation. Because the loss leg of the straddle is "locked in" shortly after the gain leg is closed, the Investor is not exposed (beyond its initial 20% interest) to economic fluctuations in the value of the foreign currency positions held by the S corporation. Only narrow differences in timing account for the fact that losses, 80% of which were economically incurred by the Promoter Shareholders, are instead allocated to the Investor. The closure of the loss leg of the straddle is delayed just long enough for the Investor to increase its interest in the S corporation holding the loss position from 20% to 100% and thereby claim an allocation of 100% of the loss. Eighty percent of the loss thus allocated to the Investor derives from economic events that occurred when the Promoter Shareholders owned most of the S corporation. Accordingly, the tax consequences to the Investor and to the Promoter Shareholders may be realigned with the economic substance of the transaction by marking the loss leg of the straddle to market under § 1.988-2(f) before the Promoter Shareholders' interests are redeemed (and the Investor's interest in the S corporation is increased) and allocating the resulting tax loss to the Promoter Shareholders and away from the Investor.

4. <u>The corporation's S election was ineffective because the Promoter, an ineligible shareholder, should be treated as the shareholder.</u>

Section 1361(b)(1)(B) provides that a "small business corporation" cannot have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2) or an organization described in § 1361(c)(6)) who is not an individual.

Section 1.1361-1(e)(1) provides that the person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder,

and the corporation does not qualify as a small business corporation. Further, § 1.1361-1(f) provides that a corporation in which any shareholder is a corporation, partnership, or certain trust does not qualify as a small business corporation.

Generally, courts limit the circumstances in which the agency principle is applied. See Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341 (1995), aff'd 115 F.3d 506 (7th Cir. 1997); Commissioner v. Bollinger, 485 U.S. 340 (1988); National Carbide v. Commissioner, 336 U.S. 422(1949).

The following facts are helpful in establishing that the Promoter Shareholders are agents of the Promoter: the promotional materials, transactional documents, and (or) the parties involved treat the Promoter as the shareholder, the Promoter directs all of the transactions, the Promoter loans to the Promoter Shareholders the funds which are contributed to the S corporation, the Promoter compensates the Promoter Shareholders for participating in the transaction, and the Promoter manages the Shareholder LLCs with sole discretion and control over such LLCs, including the LLCs' bank accounts and records.

If it is determined that the Promoter Shareholders are agents of the Promoter and thus under § 1.1361-1(e)(1) the Promoter, an ineligible shareholder (e.g. an LLC) is the beneficial owner of the S corporation stock, the S corporation election is ineffective. Accordingly, all gains and losses from the termination of the legs of the straddle should be reported as if the corporation is a C corporation. The effect of treating the corporation as a C corporation is that gains and losses should be netted for a minimal gain or loss and those gains or losses will not flow through to the shareholders.

5. Under judicial doctrines (i.e., step transaction, economic substance, and substance over form), the benefit of the deduction claimed upon the termination of the loss leg of the straddle should be disallowed.

The primary purpose of the transaction is not for the parties to trade and invest in foreign currency straddles, but rather, the transaction is a substantially meaningless series of steps that manipulate tax rules to artificially create tax losses for the Investor. Various judicial doctrines may be applicable to Notice 2002-65 transactions. The arguments have been classified under the general doctrines of step transaction, economic substance and substance over form.[9] However, even in those cases when it is appropriate to raise the argument, judicial doctrines should only be asserted as a secondary or tertiary argument, following any appropriate technical arguments.

A. Step Transaction Doctrine

In tax avoidance situations such as the Notice 2002-65 transaction described above, the substance of a transaction, rather than its form, governs the federal income tax treatment of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). The question of the applicability of the

[9] Note that some courts may categorize the doctrines in a different manner.

substance over form doctrine and related judicial doctrines requires "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). See also, Gordon v. Commissioner, 85 T.C. 309, 327 (1985); Gaw v. Commissioner, T.C. Memo. 1995-531, aff'd without published opinion, 111 F.3d 962 (D.C. Cir. 1997). One such judicially created doctrine is the step transaction doctrine.

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result.

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. [Citation omitted.]

Smith v. Commissioner, 78 T.C. 350, 389 (1982). See also Andantech v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003); Long-Term Capital Holdings, et al. v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004). Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation: the binding commitment test, the end result test, and the interdependence test.

The binding commitment test is the most limited of the three tests. It looks to whether, at the time the first step was entered into, there was a binding commitment to undertake the later transactions. This is the most rigorous test of the step transaction doctrine. Commissioner v. Gordon, 13 F.3d 577, 583 (2d Cir. 1994). If there were a moment in the series of the transactions during which the parties were not under a binding obligation, the steps cannot be collapsed under this test. As a practical matter, the binding commitment test is seldom used. See, e.g., Andantech v. Commissioner, supra; Long-Term Capital, supra.

The end result test analyzes whether the formally separate steps merely constitute prearranged parts of a single transaction intended from the outset to reach a specific end result. This test relies on the parties' intent at the time the transaction is structured. The intent the courts focus on is not whether the taxpayers intended to avoid taxes, but whether the parties intended from the outset to "to reach a particular result by structuring a series of transactions in a certain way." Additionally, they focus on whether the intended result was actually achieved. True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999).

Finally, the interdependence test looks to whether the steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the later series of steps. See Penrod v. Commissioner, 88 T.C. 1415, 1428-1430 (1987). Steps are generally accorded independent significance if, standing alone, they were undertaken for valid and independent economic or business reasons. Green v. United States, 13 F.3d 577, 584 (2d Cir. 1994); Sec. Insurance Company v. United States, 702 F.2d 1234, 1246 - 7 (5th Cir. 1983).

The existence of economic substance or a valid nontax business purpose in a given transaction does not preclude the application of the step transaction doctrine.

> "Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus, we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some nontax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.". True v. United States, supra, at 1177. See also Associated Wholesale Grocers v. United States, 927 F.2d 1517 (1991); Long-Term Capital Holdings, supra, at 193.

The three tests are not mutually exclusive and the requirements of more than one test may be met in one transaction. Further, the circumstances of a transaction need only satisfy one of the tests for the step transaction to operate. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991) (finding the end result test inappropriate but applying the step transaction doctrine using the interdependence test). And finally, even if the step transaction doctrine does not apply to an entire transaction, it may allow the Government to collapse a portion of a transaction, which may be sufficient to prevent the intended tax avoidance result. For a recent detailed discussion of the application of the three alternative tests in lease stripping transactions, see Andantech L.L.C. v. Commissioner, supra, and Long-Term Capital, supra.

The step transaction doctrine is particularly tailored to the examination of transactions involving a series of potentially interrelated steps for which the taxpayer seeks independent tax treatment. True v. United States, 190 F.3d at 1177. As a general rule, courts have held that in order to collapse a transaction, the Government must have a logically plausible alternative explanation that accounts for all the results of the transaction. Del Commercial Props. Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff'g T.C. Memo. 1999-411; Penrod v. Commissioner, supra, at 1428-1430; Tracinda Corp. v. Commissioner, 111 T.C. 315, 327 (1998). The explanation may combine steps; however, some courts have declined to apply the doctrine where the Government's alternative explanation would invent new steps or simply reorder the actual steps taken by the parties. "'Useful as the step transaction doctrine may be . . . it

cannot generate events which never took place just so an additional tax liability might be asserted.'" See Grove v. Commissioner, 490 F.2d 241, 247-248 (2d Cir. 1973), aff'g T.C. Memo. 1972-98 (quoting Sheppard v. United States, 176 Ct. Cl. 244; 361 F.2d 972, 978 (1966))); see also Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171, 196 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989); But cf. Long-Term Capital, supra, at 196 (footnote 94)(indicating that Esmark may be of limited applicability and distinguishable where all of the parties necessary to achieve the ultimate result are privy to the mutual understanding between the parties.)

The step transaction doctrine may be applicable to a transaction substantially similar to the one under discussion here, depending of course, on how the actual transaction is structured. For example, the end result test and/or the interdependence test of the step transaction doctrine could be used to disregard the Promoter Shareholders' transitory ownership of the S corporation, thereby allocating all the gains from the closing of the gain leg to the Investor. If it can be shown that Promoter Shareholders' transitory ownership of the S corporation stock added nothing of substance to the transaction (other than a transitory party to which the gain could be allocated), then the Promoter Shareholders' transitory ownership of the S corporation stock may arguably be disregarded. Collapsing the transaction and allocating both gains and losses to the Investor would match up the gains and losses from the straddle and, therefore, prevent the Investor from being allocated the loss without the gain.

Examiners should look at the facts on a case-by-case basis to determine if the step transaction doctrine would be applicable in their specific case.

B. Economic Substance

Discretion must be exercised in determining whether to utilize an economic substance argument[10] in all cases. The doctrine of economic substance should be considered, but only in cases where the facts show that the transaction at issue was primarily designed to generate the tax losses, with little if any possibility for profit, and that such was the expectation of all the parties. Specifically, in a Notice 2002-65 transaction, the argument should not be raised when taxpayers can objectively demonstrate that the structure of the transaction has the real potential to allow the S corporation to realize substantial economic returns and substantial pre-tax profits.

The wide variety of facts required to support its application should be developed at the Exam level before this argument can be made. The sources for these facts will be similar: documents obtained from taxpayers, the promoter and other third parties; interviews with the same; and an analysis of financial data and industry practices. Summons should be promptly issued whenever necessary.

[10] This doctrine is also referred to by the courts as the "sham transaction" or "sham in substance" doctrine. For purposes of this document, the doctrine is referred to as the "economic substance" doctrine.

I. Background

In order to be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. See Frank Lyon Co. v. U.S., 435 U.S. 561, 583-84 (1977). A transaction has economic substance if it is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and economic situation and the transaction has a reasonable possibility of profit. See Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1993); Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993); ACM P'ship v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

A transaction's economic substance is determined by analyzing the *subjective intent* of the taxpayer entering into the transaction and the *objective economic substance* of the transaction. The various United States Courts of Appeals differ on whether the economic substance analysis requires the application of a two-prong test or is a facts and circumstances analysis regarding whether the transaction had a "practical economic effect," taking into account both subjective and objective aspects of the transaction. Compare Rice's Toyota World and Pasternak at 898 (applying the two-pronged test) with Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995)(applying the facts and circumstances analysis).[11] See also Gilman v. Commissioner, 933 F.2d 143, 148 (2d Cir. 1991)("The nature of the economic substance analysis is flexible…").

Moreover, among the United States Courts of Appeals that apply a two-prong test, there is disagreement as to whether the test is disjunctive or conjunctive. For example, the Fourth Circuit Court of Appeals applies the test disjunctively: a transaction will have economic substance if the taxpayer had either a nontax business purpose or the transaction had objective economic substance. Rice's Toyota World at 91-92.[12]

[11] In the Third Circuit, in determining "whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes", the analysis "turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them." ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), aff'g in part and rev'g in part T.C. Memo. 1997-115, cert. denied, 526 U.S. 1017 (1999)(citing Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990) [other citations omitted]. See also In re: CM Holdings, Inc., 301 F.3d 96, 102 (3rd Cir. 2002). However, this analysis does not require a rigid two-step analysis. See id. Similarly, in the Tenth Circuit, although the court recognized the two-prong test from Rice's Toyota, the court held "The better approach, in our view, holds that 'the consideration of business purpose and economic substance are simply more precise factors to consider in the [determination of] whether the transaction had any practical economic effects other than the creation of income tax losses." James v. Commissioner, 899 F.2d 905, 908-9 (10th Cir. 1990)(citation omitted).

[12] The Eighth Circuit appears to apply the disjunctive test provided in Rice's Toyota, but indicates that a rigid two-part test may not be required. Shriver v. Commissioner, 899 F.2d 724, 725-8 (8th Cir. 1990). The DC Circuit and Federal Circuit apply the disjunctive test. See Horn v. Commissioner, 968 F.2d 1229, 1236 (DC Cir. 1992); Drobny v. U.S., 86 F.3d 1174 (Fed. Cir. 1996)(unpublished opinion). It is unclear whether the Second Circuit applies the test disjunctively or under a facts and circumstances analysis. Compare Gilman, supra, at 148 (citing Jacobson v. Commissioner, 915 F.2d 832, 837 (2d Cir. 1990)(additional citations omitted))("A transaction is a sham if it is fictitious or if it has no business purpose or economic effect.") with TIFD III-E Inc. v. U.S., 2004 WL 2471581, 12(D.Conn. Nov 01, 2004) ("The decisions in this circuit are not perfectly explicit on the subject. Recently, for example, Judge Arterton adopted the more flexible standard, but acknowledged some potentially contrary, or at least ambiguous, language in Gilman. Long-Term Capital Holdings v. United States, 2004 WL 1924931, 39 n. 68 (D.Conn. Aug.27, 2004). That ambiguity, however, does not affect the decision of this case. As I will explain, under either reading I would conclude that the Castle Harbour transaction was not a 'sham.' The transaction had both a nontax economic effect and a nontax business motivation, satisfying both tests and requiring that it be given effect under any reading of the law.") Similarly, in Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001), the Fifth Circuit considered both

However, the Sixth Circuit Court of Appeals and Eleventh Circuit Court of Appeals apply the test conjunctively: a transaction will have economic substance only if the taxpayer had both a nontax business purpose and the transaction had objective economic substance. See Pasternak at 898 and United Parcel Service of America v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001)(citing Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989)).

II. Subjective Intent – Business Purpose

The subjective business purpose inquiry "examines whether the taxpayer was induced to commit capital for reasons relating only to tax considerations or whether a nontax motive, or legitimate profit motive, was involved." Shriver v. Commissioner, 899 F.2d 724, 726 (8th Cir. 1990)(citing Rice's Toyota World, supra). To determine that intent, the following credible evidence is considered: (i) whether a profit was possible;[13] (ii) whether the taxpayer had a nontax business purpose;[14] (iii) whether the taxpayer, or its advisors, considered or investigated the transaction, including market risk;[15] (iv) whether the entities involved in the transaction were entities separate and apart from the taxpayer doing legitimate business before and after the transaction;[16] (v) whether all the purported transactions were engaged in at arm's-length with the parties doing what the parties intended to do;[17] and (vi) whether the transaction was marketed as a tax shelter in which the purported tax benefit significantly exceeded the taxpayer's actual investment.[18]

Taxpayers engaging in a Notice 2002-65 transaction will likely assert a profit objective as the nontax business purpose. The lack of economic substance argument should be asserted only in transactions where it can be established that the transaction did not have a realistic pre-tax profit potential. Thus, evidence should be sought to demonstrate that the taxpayer and the promoter primarily planned the transaction for tax purposes.

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the standard in Rice's Toyota World (that there be *no business purpose* and *no reasonable possibility of a profit*) [emphasis added] and the test in ACM (that these are mere factors in determining economic substance) and declined to accept one standard over the other.

[13] See Goldstein v. Commissioner, 364, F.2d 734 (2d Cir. 1966); Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995); Winn-Dixie, Inc. v. Commissioner, 113 T.C. 254 (1999) aff'd in part Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002).

[14] See Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989); Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir 1990); Newman v. Commissioner, 894 F.2d 560, 563 (2d Cir. 1990); Winn-Dixie, Inc. v. Commissioner, 113 T.C. 254 (1999) aff'd in part Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001); Salina Partnership v. Commissioner, T.C. Memo 2000-352 (2000).

[15] See Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989); Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989); Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir 1990); Salina Partnership v. Commissioner, T.C. Memo 2000-352 (2000); Nicole Rose Corp. v. Commissioner, 117 TC 328 (2001).

[16] See IES Industries Inc. v. Commissioner, 253 F.3d 350, 355 - 56 (8th Cir. 2001).

[17] See Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989); Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989); James v. Commissioner, 899 F.2d 905 (10th Cir. 1990); Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993); IES Industries Inc. v. Commissioner, 253 F.3d 350, 356 (8th Cir. 2001).

[18] See Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993).

Such evidence should include items such as the following: (i) documents or other evidence that the Notice 2002-65 transactions were sold as tax shelters with limited consideration of the underlying economics of the transaction; (ii) evidence that the Investor, or Investor's advisors, did not investigate the market risk prior to entering into the Notice 2002-65 transaction; and (iii) evidence that the independent parts making up the Notice 2002-65 transaction, were not entered into at arm's length or that the S corporation or its shareholders did not act as independent entities while engaging in the Notice 2002-65 transaction

A direct source of such evidence regarding the taxpayer's contention of a nontax business purpose is correspondence between the Promoter and the Investor, including, but not limited to, offering memos, letters identifying tax goals, emails and in-house communications at the offices of both the promoter and the accommodating parties. Written correspondence is the best evidence, but evidence of oral communications regarding tax goals is also useful. Indirect sources of the same include correlations between tax losses generated and tax losses requested, and between the Investor's income and the tax losses generated, particularly if it can be shown that the income to be sheltered was attributable to an unusual windfall, like the liquidation of stock options, or sale of a business. Demonstrations of similarities of the nature and extent of tax losses acquired by other clients of the Promoter in this shelter (the "universe") can be very important as well.

III. Objective Economic Substance

Courts have used different measures to determine whether a transaction has objective economic substance. These measures include whether there is a potential for profit, and whether the transaction otherwise altered the economic relationships of the parties.

This determination is generally made by reference to whether there was a reasonable or realistic possibility of profit.[19] See e.g., Gilman v. Commissioner, 933 F.2d 143, 146 (2d Cir. 1991)(determine economic substance based on "if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.") The amount of profit potential necessary to demonstrate objective economic substance may vary by jurisdiction.[20] However, a transaction is not required to result in a profit and similar transactions do not need to be profitable in order for the taxpayer's transaction to have economic substance. See Cherin v. Commissioner, 89 T.C. 986, 994 (1987). See also Abramson v. Commissioner, 86 T.C. 360 (1986)(holding that potential for profit is found when a transaction is carefully conceived and planned in accordance with

[19] The appropriate inquiry is not whether the taxpayer made a profit but whether there was an objective reasonable possibility that the taxpayer could earn a pre-tax profit from the transaction.

[20] In assessing the role of profit in determining whether a transaction has economic substance, the Third Circuit has held, based on Sheldon, that "a prospect of a nominal, incidental pre-tax profit which would not support a finding that the transaction was designed to serve a nontax profit motive." ACM, supra, at 258 (citing Sheldon v. Commissioner, 94 T.C. 738, 768 (1990)). In making this determination, the court took into account transaction costs. Id. at 257. In this evaluation, some courts have considered a small chance of a large payoff to support a finding of economic substance. See Jacobson v. Commissioner, 915 F.2d 832 (2d Cir. 1990)(citing §1.183-2(a) (1990)).

standards applicable to a particular industry, so that judged by those standards the hypothetical reasonable businessman would make the investment).

To determine whether a transaction has a realistic possibility of profit, courts have used both a cash flow analysis and a net present value analysis. Compare James v. Commissioner, 899 F.2d 905 (10th Cir. 1990); Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Winn-Dixie, Inc. v. Commissioner, 113 T.C. 254 (1999) aff'd in part Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) with ACM P'Ship v. Commissioner, T.C. Memo 1997-115 aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998); Soriano v. Commissioner, 90 T.C. 44, 54-57 (1988); Walford v. Commissioner, T.C. Memo 2003-296. Although it is unclear whether a court would find that a transaction lacked economic substance if it had a negative net present value but a positive cash flow potential, courts that have utilized the cash flow method have appeared willing to find objective economic substance in transactions with a positive cash flow potential. See e.g. Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990). In addition, it does not appear that any court has specifically repudiated the cash flow method in favor of the net present value method. See e.g. ACM P'Ship v. Commissioner, T.C. Memo 1997-115 aff'd in part and rev'd in part 157 F.3d 231, 259 (3d Cir. 1998).[21] Because it is unclear whether the net present value method or the cash flow method would be more acceptable, a Notice 2002-65 transaction under review should be analyzed using both the cash flow method and the net present value method.[22] See also Rothschild v. U.S., 186 Ct. Cl. 709 (Ct. Cl. 1969); Cohen v. Commissioner, 44 B.T.A. 709 (1941).[23] Generally speaking, a potential for profit is present when a transaction is carefully conceived and planned in accordance with standards applicable to a particular industry, so that judged by those standards the hypothetical reasonable businessman would participate in the investment.[24]

In developing this prong of the argument, it is not enough to show that the transaction was not profitable or was only nominally profitable. The facts must support a conclusion that the taxpayer could not profit from the transaction or, at best, could realize only a nominal profit. All direct and indirect fees and costs paid by the taxpayer, any offsetting positions related to the overall transaction, and any indemnity agreements between the accommodating parties and the promoter should be determined. It is essential that the accommodating parties be interviewed carefully in this regard, for any actual economic

[21] In ACM, the Appellate Court held that it was not reversible error for the Tax Court to reduce the income expected to be generated to its net present value, but did not hold that a net present value analysis was the only appropriate manner for determining the profit potential of the particular transaction so long as the method adopted serves as an accurate gauge of the reasonably expected economic consequences of a transaction.

[22] The present value of any asset is equal to the expected future cash flows that the holder of the asset will receive, discounted at the rate of return offered by comparable investment alternatives. Future cash flows are discounted to take into account the time value of money and risk. The net present value of an investment is calculated by subtracting the cost of the investment from its present value. An investment is considered profitable under an out-of-pocket cash flow analysis if the cash flows obtained from holding the investment exceed the costs of making the investment. The out-of-pocket profit calculation does not take into account the time value of money or the risk of future cash flows.

[23] Cf. Commissioner v. Groetzinger, 480 U.S. 23 (1987). In Groetzinger, the United States Supreme Court recognized that gambling may be a trade or business for purposes of § 162.

[24] Cherin v. Commissioner, 89 T.C. 986,994 (1987).

gain of the taxpayer would be their economic loss, which is unlikely. Evidence of circular flows of money and the invalidity of any loans must be fully developed.

Certain courts have been willing to recognize the economic substance of a transaction when, in lieu of a reasonable possibility of profit, the taxpayer establishes that the transaction altered the economic relationships of the parties. See Knetsch v. United States, 364 U.S. 361 (1960). For example, courts have found that objective economic substance existed where the transaction created a genuine obligation enforceable by an unrelated party. See United Parcel Services, supra, at 1018; Sacks, supra, at 988-990 (the use of recourse debt created a genuine obligation for the taxpayer and this illustrated a genuine economic effect); Black and Decker Corp. v. U.S., 340 F. Supp. 2d 621 (M.D. Oct. 22, 2004) ("The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes.")(citing *Rice's Toyota*, supra, at 96).[25] However, it does not appear that this secondary standard has been universally accepted. See, for example, Gilman v. Commissioner, 933 F.2d 143, 147-48 (2d Cir. 1991) in which the court rejected the taxpayer's argument that the relevant standard for determining economic substance is whether the transaction may cause any change in the economic positions of the parties (other than tax savings) and that where a transaction changes the beneficial and economic rights of the parties it cannot be a sham. See also Long Term Capital Holdings' v. United States, 330 F. Supp.2d 122 (D. Conn. 2004) quoting Gilman v. Commissioner.

In determining in which cases an economic substance argument should be advanced, it would be helpful to show that the Promoter controlled all critical phases of the underlying transaction, from the formation of the necessary entities, through coordination with the Promoter Shareholders, to the timing and structure of the trades themselves. Direct sources of such evidence will come primarily from the transactional documents as well as correspondence from, and interviews with, all the parties. The scope of the Promoter's control must be shown to be broader than in otherwise legitimate investments. To the extent that any witness provides some rationalization for having surrendered control of virtually all critical aspects of the transaction, that should be memorialized.

If it is determined that the transaction as a whole lacks economic substance, the noneconomic deduction claimed by the Investor should be disallowed.

IV. Other Considerations

If it is determined that it is appropriate to assert economic substance with respect to a Notice 2002-65 transaction, consideration must be given to appellate venue. As discussed above, the various Courts of Appeals apply different standards in determining whether a transaction lacks economic substance. Prior to asserting economic

[25] The court in Coltec Industries, Inc. v. U.S., No. 01-072T (Ct. Cl. October 29, 2004), cites Black and Decker, supra, (and other cases) for the premise that satisfaction of the tax avoidance and business purpose tests of section 357(b) means that the economic substance test is satisfied. Coltec Industries, Inc. (citing Black and Decker, supra, at *6) [citations omitted].

substance, seek Counsel assistance to determine the appropriate standard. Moreover, although certain Courts of Appeals might view a nominally profitable transaction as lacking economic substance, based on the taxpayer's subjective intent of tax avoidance with no other nontax purpose, an economic substance argument generally should not be asserted in such cases because it will be extremely difficult to establish that the taxpayer lacked the requisite pretax profit motive.

C. Substance Over Form Doctrine

Transactions that literally comply with the language of the Code but produce results other than what the Code and regulations intend are not given effect. In Gregory v. Helvering, 293 U.S. 465, 470 (1935), the Supreme Court found that even though the transaction did comply with the Code, "the transaction upon its face lies outside the plain intent of the statute." Therefore, the Court found that to give the transaction effect would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. In Knetsch v. United States, 364 U.S. 361 (1960), the Supreme Court once again found a transaction abusive, even though the transaction met every literal requirement of the Code. The Court stated that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." Id. at 366.

Even if it is found that the Notice 2002-65 transaction described in this paper literally complies with the Code and regulations, the transaction produces results other than what the Code and regulations intended in that gain from the gain leg and loss from the loss leg of a straddle are separated and the Shareholder LLCs are allocated the gain and the Investor is allocated the loss, but neither party likely has any economic gain or loss from the transaction. The only apparent consequence is that the Investor claims a loss for tax purposes far in excess of its costs. While the form of this transaction purports to show that the Shareholder LLCs are shareholders, it is likely that the Shareholder LLCs do not enjoy a benefit commensurate with their shareholder status. For example, the Shareholder LLCs allocated gain from the closing of the gain leg, which is never intended to be distributed to them. Moreover, because the redemption of the Shareholder LLCs shares for approximately the amount of the Shareholder LLCs' investment is pre-planned and certain, there appears to be nothing of substance to be realized in this abusive transaction aside from substantial tax savings for the Investor.

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support the transaction is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752 (1975); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001). When a transaction is treated as a sham, the form of the transaction is disregarded and the proper tax treatment of the transaction must be determined. Because the Notice 2002-65 transaction appears to be a sham, the form of the transaction should be disregarded and the Investor should be treated as the sole owner of the S corporation for purposes of allocating both the gain and the loss from the

termination of the straddle positions. See Comtel v. Commissioner, 376 F.2d 791(2d Cir. 1967) (the court applied the substance over form doctrine to determine that the taxpayers' presence in this transaction was merely for the purpose of providing a financing arrangement, a loan for a third party). Accordingly, the Investor should be required to include 100% of the gain from the gain leg into income when the leg is terminated. This has the effect of matching the income from the gain leg with the losses from the loss leg and reflecting the true economics of the transaction.

6. The transaction costs incurred in connection with this transaction, including promoter's fees, accounting fees, legal fees and consulting fees, are not deductible under §§ 162 or 212.

Section 162 provides generally for the deduction of ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, transaction costs incurred in connection with a transaction designed solely to provide tax benefits for participants are not deductible under § 162. See Brown v. Commissioner, 85 T.C. 968, 1000 (1985), aff'd sub nom. Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988); See also Leslie v. Commissioner, 146 F.3d 643, 650 (9th Cir. 1998) (deduction disallowed for fees paid to purchase deductions in tax-motivated transaction, citing Brown); Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 294 (1999) (administrative fees disallowed as the product of a sham), aff'd, 254 F.3d 1313 (11th Cir. 2001); Price v. Commissioner, 88 T.C. 860, 886 (1987), aff'd without published opinion, 1990 U.S. App LEXIS 20422 (10th Cir. Oct. 26, 1990) (deduction for fees paid to acquire tax losses disallowed because neither a cost of doing business nor incurred with an intent to make a profit independent of tax consequences, citing Brown).

The transaction costs incurred by the shareholders or by the S corporation in conjunction with this transaction, including promoter's fees, accounting fees, legal fees, and consulting fees, are paid for participation in the transaction. The fees incurred constitute payments to purchase tax benefits for the shareholders and, as such, are not deductible under § 162 by either the S corporation or shareholders.

Section 212 generally provides for the deduction by an individual of ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income, (2) for the management, conservation, or maintenance of property held for the production of income, or (3) in connection with the determination, collection, or refund of any tax. Deductions under § 212, however, cannot be taken for costs incurred in obtaining tax advice in furtherance of a sham transaction. See Dooley v. Commissioner, 332 F.2d 463, 468 (7th Cir. 1964); see also Brown v. Commissioner, 85 T.C. at 1000.

7. The Service should assert the I.R.C. § 6662 accuracy-related penalty against taxpayers who entered into this transaction.

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment[26] attributable to, among other things: (1) negligence or disregard of rules or regulations and (2) any substantial understatement of income tax. There is no stacking of the accuracy-related penalty components. § 1.6662-2(c). Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial understatement). See D.H.L. Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded by, 285 F.3d 1210 (9th Cir. 2002), where the IRS alternatively determined that either the 40 percent accuracy-related penalty attributable to a gross valuation misstatement under § 6662(h) or the 20 percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. § 6662(b).

Negligence

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See § 6662(c) and § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g 43 T.C. 168 (1964). Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. § 1.6662-3(b)(1)(ii). The accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to evaluate the transaction properly.

"Disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. A disregard of rules or regulations is careless if the taxpayer does not exercise reasonable diligence in determining whether a position taken on its return is contrary to the rule or regulation. A disregard is reckless if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, disregard of the rules and regulations is intentional where the taxpayer has knowledge of the rule or regulation that it disregards. § 1.6662-3(b)(2).

Substantial Understatement

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown

[26] For purposes of § 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax exceeds the tax reported on the return. See § 6664(a).

on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). § 6662(d)(1).[27] An understatement generally means the excess of the correct tax over the tax reported on an income tax return. § 6662(d)(2). This excess is determined without regard to items to which § 6662A (discussed below) applies. The reportable transaction understatement calculated under § 6662A(b)(1), however, is added to the understatement calculated under § 6662(d)(2) for purposes of determining whether an understatement is substantial under § 6662(d)(1).

Under § 6662A(e)(1)(B), in the case of an understatement, the addition to tax under § 6662(a) applies only to the excess of the amount of the substantial understatement over the aggregate amount of the reportable transaction understatements. Accordingly, the accuracy-related penalty on underpayments attributable to a substantial understatement of income tax does not apply to an underpayment attributable to an understatement on which the § 6662A penalty is imposed.

Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for the treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. § 6662(d)(2)(B).

In the case of items of taxpayers, other than corporations, attributable to tax shelters, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. § 6662(d)(2)(C)(i).[28] In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. § 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the underpayment attributable to the understatement unless the reasonable cause exception applies. See § 1.6664-4(e) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

For purposes of § 6662(d), a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. § 6662(d)(2)(C). The arrangement described above has as a significant purpose the avoidance or evasion of federal income tax and it a "tax shelter" for purposes of l§ 6662(d). Thus, no reduction in the understatement will be available for the shareholder unless there was substantial authority for the tax treatment of the item and the taxpayer reasonably believed that it was more likely than not the proper treatment.

[27] For tax years ending after October 22, 2004, an understatement of a corporation is substantial if it exceeds the lesser of (1) 10 percent of the tax required to be shown on the return (or, if greater, $10,000), or (2) $10 million. P.L. 108-357, § 819(a).

[28] For tax years ending after October 22, 2004, no taxpayer may reduce any portion of an understatement attributable to a tax shelter item. P.L. 108-357, § 812(d).

There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. § 1.6662-4(d)(3). For a discussion of how to analyze whether there is substantial authority see § 1.6662-4(d)(3)(ii).

A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer analyzes the pertinent facts and authorities and, based on his or her independent analysis, reasonably concludes in good faith, that there is a greater than 50 percent chance that the tax treatment of the item will be upheld if challenged by the Service. The taxpayer may also reasonably rely, in good faith, on the opinion of a professional tax advisor. The opinion must clearly state that, based on the advisor's analysis of the facts and authorities, the advisor concludes that there is a greater than 50 percent chance that the tax treatment will be upheld if the Service challenged the position. § 1.6662-4(g)(4)(i)(A) and (B).

The Reasonable Cause Exception

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. § 1.6664-4(b)(1). All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, and the sophistication of the taxpayer must be developed to determine whether there was reasonable cause and good faith. Generally, the most important factor is the extent of the taxpayer's effort to assess their proper tax liability. Id. See Larson v. Commissioner, T.C. Memo. 2002-295. See also Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988) (taxpayers did not act reasonably when they failed to investigate and simply relied on offering circulars and the advice of their accountant, who had no first-hand knowledge about the venture); Long Term Capital Holdings v. United States, 330 F.Supp.2d 122 (D. Conn. 2004) (taxpayer could not rely on advice that it did not receive before it filed its return).

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice constitutes reasonable cause and good faith only if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith. § 1.6664-4(b)(1), (c). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. § 1.6664-4(b)(1).

The advice must be based upon how the law relates to the pertinent facts and circumstances. For example, the advice must take into account the taxpayer's purpose

(and the relative weight of those purposes) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. § 1.6664-4(c)(1)(i).

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. § 1.6664-4(c)(1)(i). Accordingly, examiners should evaluate the accuracy of critical assumptions contained in any opinion letter.

In any tax shelter transaction, the taxpayer has a duty to fully investigate all aspects of the transaction before proceeding. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221, 233-34 (3d Cir. 2002); Novinger v. Commissioner, T.C. Memo. 1991-289. Moreover, if the tax advisor is not versed in the details of the transaction, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990).

A professional tax advisor's lack of independence is not alone a basis for rejecting a taxpayer's claim of reasonable cause and good faith. However, the fact that a taxpayer knew or should have known of the advisor's lack of independence is strong evidence that the taxpayer may not have relied in good faith upon the advisor's opinion. Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994).

Special Rule for Tax Shelter Items of Corporations

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply. A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that the treatment was more likely than not the proper treatment. § 1.6664-4(f)(2)(i). Because many corporations rely on the opinion of a tax professional, the opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "belief" requirements is necessary to a reasonable cause finding, this may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were

unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. § 1.6664-4(f)(3).

Disclosure Initiative under Announcement 2002-2

Accuracy-related penalties will generally be waived for taxpayers that properly disclosed the Notice 2002-65 transactions as part of the Announcement 2002-2 disclosure initiative. As explained in Announcement 2002-2, however, the penalty waiver is not available in situations where the disclosed item had been raised as an examination issue prior to the time when the taxpayer made the disclosure. In addition, the penalty waiver is not available for certain transactions that did not actually occur, transactions that involve fraudulent concealments, and transactions that involve deductions of personal, household, or living expenses.

8. The § 6662A accuracy-related penalty provisions apply to Notice 2002-65 transactions.

Section 6662A establishes a 20 percent accuracy-related penalty for any reportable transaction understatement, subject to a reasonable cause exception. The penalty is increased to 30 percent if the taxpayer does not adequately disclose relevant facts regarding a reportable transaction. The penalty applies to taxable years ending after October 22, 2004. Section 6664(d) provides a heightened reasonable cause exception for this penalty. To establish reasonable cause and good faith for purposes of avoiding the § 6662A penalty, the following requirements must be satisfied: (1) the taxpayer must have adequately disclosed the transaction in accordance with § 6011; (2) there is or was substantial authority for the tax treatment of the item; and (3) the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment. See also Notice 2005-12, 2005-7 I.R.B. 494. The taxpayer may not rely on a "disqualified opinion" or on the opinion of a "disqualified tax advisor" to establish reasonable belief. § 6664(d)(3)(B).

Section 6662A does not apply to any portion of an understatement on which the § 6663 fraud penalty or the § 6662(h) accuracy-related penalty for a gross valuation misstatement is imposed. Section 6662(e) (substantial valuation misstatement) does not apply to any portion of an understatement on which a penalty under § 6662A is imposed.

With respect to taxable years ending after October 22, 2004, consideration should be given as to whether the § 6662A penalty applies. Scenarios in which this issue may arise include returns filed for the 2004 or later tax years which claim carryforwards of losses from earlier years.